

Section 1

Audit framework and regulation

CREATING GREAT OUTCOMES

through professional qualification training
and study abroad services and preparation

Contents

1. Concepts of audit and assurance
2. External audit 95%
3. Corporate governance 公司治理
4. Professional ethics & Code of Ethics and Conduct 必考
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6. Other matters about internal audit function

1 Concepts of audit and assurance

- An **audit** is an evaluation of an organisation, system or process. Audits are performed to ascertain the **validity and reliability** of information, and also provide an assessment of a system's internal control.
- **External audit** is an "**independent** examination and expression of opinion on the financial statements of an entity".
- The purpose of **external audit** is to obtain sufficient appropriate audit evidence on which to base the audit opinion.

1

1.1 What is assurance?

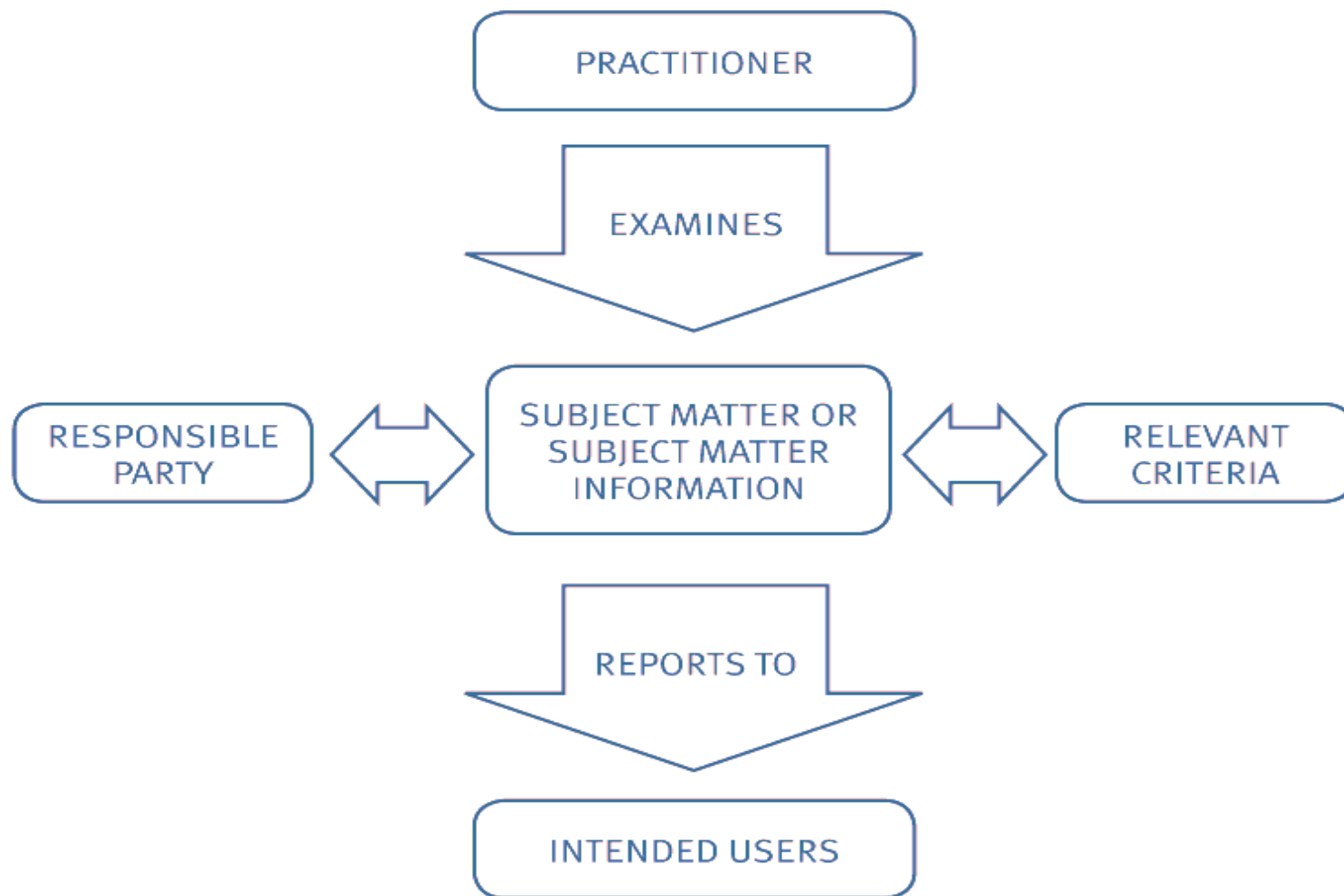
“An engagement in which a **practitioner** 鉴证师 express a conclusion designed to enhance degree of confidence of the **intended users** other than the **responsible party** about the outcome of the evaluation or measurement of a **subject matter** against **criteria**” 标准

(International Audit and Assurance Standards Board Handbook)

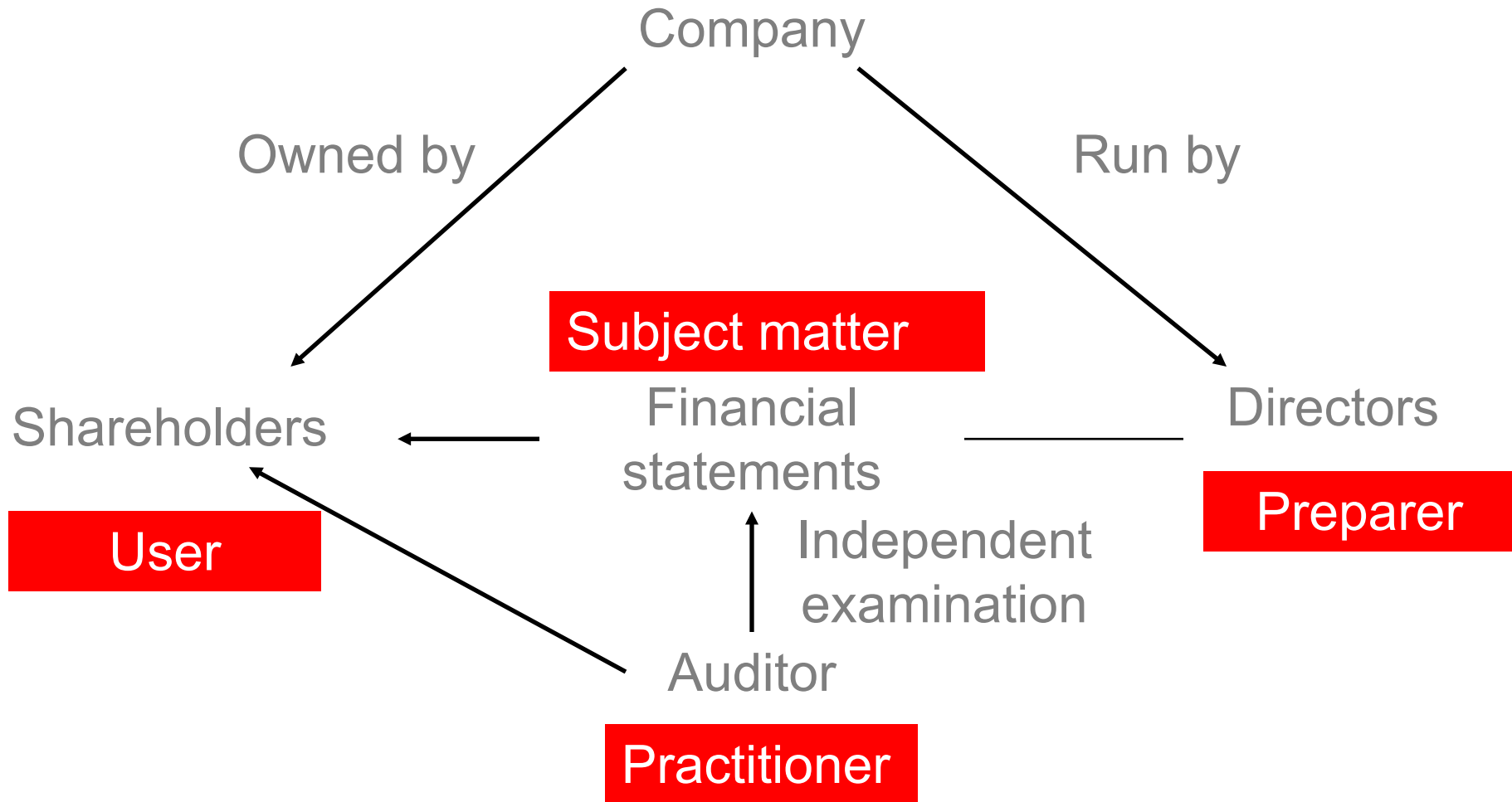
1.1 What is assurance?

- Five elements
 - A three party relationship between:
 - the Practitioner
 - the responsible party
 - the intended users
 - A subject matter
 - Suitable criteria
 - Sufficient appropriate evidence
 - A written report

Assurance Engagement



1 The elements of **audit engagement**





1.2 Level of assurance 保证程度 provided by audit and review



审计和审阅

- **Limited** level of assurance
 - (i) Presented in a **negative** way
 - (ii) “nothing has come to our attention”...that the subject matter is not free from material misstatement.

- **Reasonable** level of assurance
 - (i) A **positive** opinion
 - (ii) The subject matter conforms in all material respects with the identified criteria
 - (iii) E.g. statutory audit: give a true and fair view

1.2 Level of assurance provided by audit and review

Reasonable Assurance (Audit)	Limited Assurance (Review)
Sufficient appropriate evidence to draw reasonable conclusion	Sufficient appropriate evidence to draw limited conclusion
Confirms in all material respects	Is plausible in the circumstances
Positively words opinion	Negatively words opinion
High level	Moderate or lower level
Evidence: TOC & SP	Evidence: Enquiry & AP

Positive & Negative words opinion

- *“ In our opinion the financial statements give a true and fair view of the financial position and performance of the company as at 31 December 2009. ”*
- *“ Nothing has come to our attention that causes us to believe that the financial statements as of 31 December 2009 are **not** prepared, in all material respects, in accordance with an applicable financial reporting framework:”*

[June 2012 exam Q 1(d)]

合理保证
(财务报表审计)

有限保证
(财务报表审阅)

目标

在可接受的低审计风险下，以积极方式对财务报表整体发表审计意见，提供高水平的保证

在可接受的审阅风险下，以消极方式对财务报表整体发表审阅意见，提供有意义水平的保证。**该保证水平低于审计业务的保证水平**

证据收集程序

通过一个不断修正的、系统化的执业过程，获取充分、适当的证据，证据收集程序包括**检查记录或文件、检查有形资产、观察、询问、函证、重新计算、重新执行、分析程序等**

通过一个不断修正的、系统化的执业过程，获取充分、适当的证据，证据收集程序受到有意识的限制，主要采用**询问**和**分析程序**获取证据

所需证据数量
检查风险
财务报表的可信性

较多
较低
较高

较少
较高
较低

提出结论的方式

以积极方式提出结论。
例如：“我们认为，ABC公司财务报表在所有重大方面按照企业会计准则和《××会计制度》的规定编制，公允反映了ABC公司2014年12月31日的财务状况以及2014年度的经营成果和现金流量。”

以消极方式提出结论。
例如：“根据我们的审阅，我们没有注意到任何事项使我们相信，ABC公司财务报表没有按照企业会计准则的规定编制，未能在所有重大方面公允反映被审阅单位的财务状况、经营成果和现金流量。”

Absolute assurance

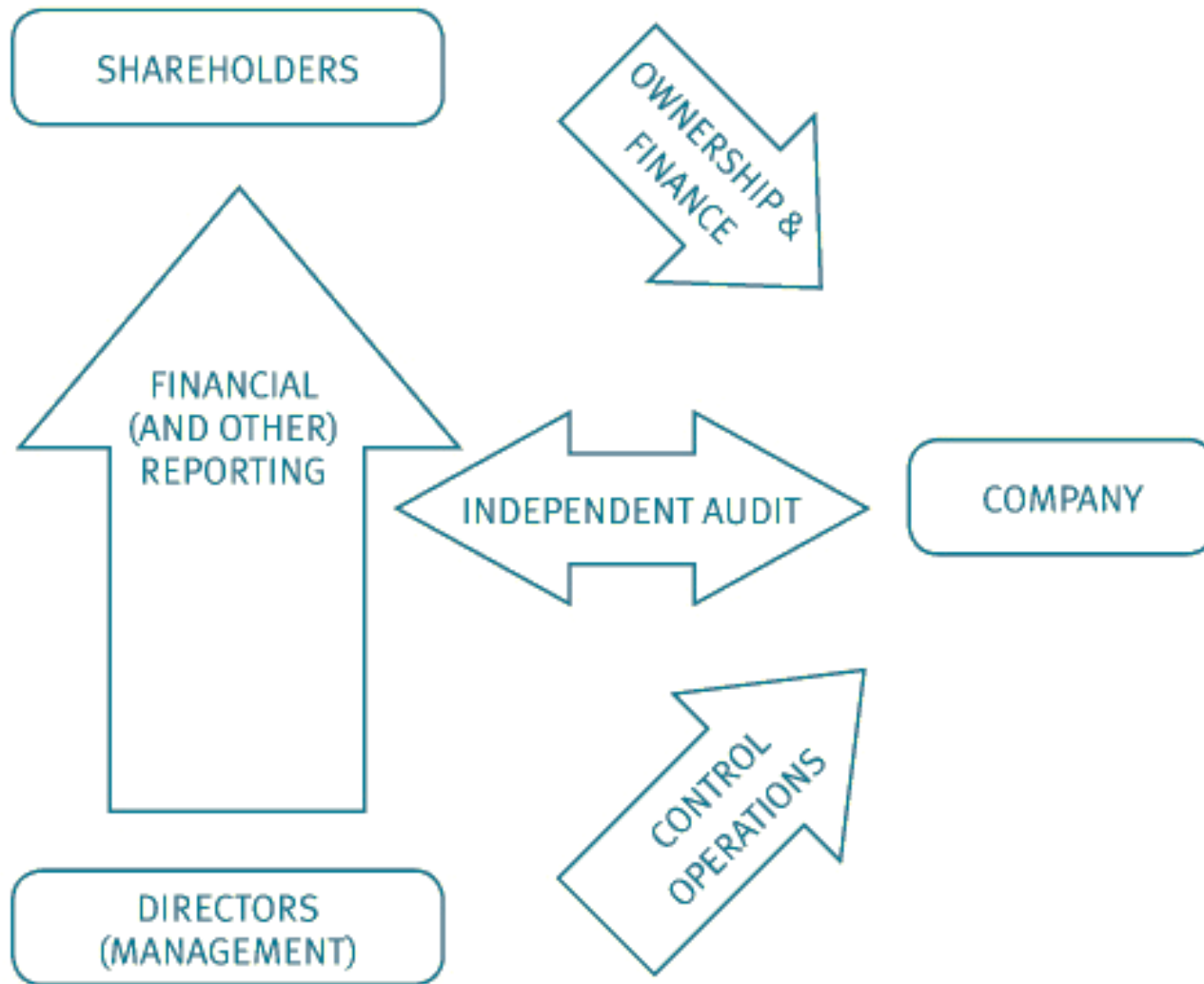
- Absolute assurance would be the **certification** that something is **absolutely correct**.
- This level of assurance cannot be given on an assurance engagement, due to **the inherent limitations** of the engagement



Expectation Gap

2

External audit



2 Act as an external auditor

As a **person**:

- Member of a recognised supervisory body(RSB), e.g. ACCA;
- Allowed by the rules of that body to be an auditor;
- Someone directly authorised by the state;

As a **firm**:

- Controlled by members of suitably authorised supervisory body
- A firm directly authorised by the state;


- **Excluded by law**
 - Who manage or work for the company being audited;
 - Who have business or personal connections with the company.
- **Excluded by the code of ethics** (discuss in later chapter)

2.1 Regulatory environment about external audit

- Most companies(except small or dormant companies) are required to have an external audit **by law**, which are referred to as “**statutory audits**”. 法定审计
- Statutory audits have to be carried out in accordance with the **legal requirements** of the country in which they are taking place.

2.2 Appointment, rights, removal and resignation of auditors

2.2.1 Appointment

- Auditors are appointed by the **shareholders** in general meetings.
- **Before Acceptance**
 - (i) *Independence (connected with Threats)* 
 - (ii) Resources
 - (iii) Risks
 - (iv) Conflicts of interests

2.2 Appointment, rights, removal and resignation of auditors

2.2.1 Appointment

➤ Before Acceptance

- Auditors should:
 - (i) Ask client for permission to contact outgoing auditor
 - (ii) If denied, reject the audit
 - (iii) Ask outgoing auditor if any “relevant matters”
 - (iv) Outgoing auditor should ask for permission to reply
 - (v) If denied, the new auditor should be informed of this denial.

2.2 Appointment, rights, removal and resignation of auditors

Once appointed (after acceptance)

2.2.2 Rights

- access to the company's books and records
- to receive all information and explanations necessary for the audit
- to receive notice of and attend any general meeting for members of the company
- to be heard at such meetings
- to receive copies of any written resolutions of the company
- Other rights relating to removal and resignation

2.2 Appointment, rights, removal and resignation of auditors

2.2.3 Removal

- The auditor can only be removed by shareholders at a General Meeting with a majority vote.
- The auditor must produce a “statement of circumstances”. If there are no circumstances that need attention, then a statement of no circumstances is required.
- If the auditors have been removed before the end of their term, they must notify ACCA.

2.2 Appointment, rights, removal and resignation of auditors

2.2.4 Resignation

- Resign in writing
- In all cases, a “statement of circumstances” is required, even if it says there are no circumstances that need to be reported.
- Connected with Removal rights

2.3 The Limitations of external audits

- Financial information includes subjective and judgmental matters IAS16 PPE
- **Inherent limitations** of controls used as audit evidence
- Representations from management may have to be **relied upon as the only source of evidence** in some areas 管理层声明书（保证书）
- Evidence is persuasive not conclusive 说服审计师本人
- **Do not review 100%** of the transactions
- **Materiality**

Expectation Gap

They Believe	Actually
Auditors test all transactions and balances	On sample basis
Detect all fraud	Reasonable assurance that FS are free from material misstatement, which may be caused by fraud
Auditor are responsible for preparing the FS	The responsibility of management

OT case Test

➤ Your firm has been approached to perform the external audit of Perth Co. As this is the first year the company has required an audit, the directors are unsure about the purpose of the audit, the level of assurance provided and the benefits of having an audit.

1. Auditors aim to give absolute assurance over the accuracy of the Financial Statements. True or False?

A True

B False

2. Which of the following is not one of the five elements of an assurance engagement?

A Subject matter

B Suitable criteria

C Assurance file

D Written report

OT case Test

3. Which of the following is NOT a benefit of an audit?
- A Increased credibility of the financial statements
 - B Deficiencies in controls may be identified during testing
 - C Fraud may be detected during the audit
 - D Sampling is used
4. Which of the following statements is false?
- A The auditor will express an opinion as to whether the financial statements show a true and fair view
 - B The audit opinion will provide reasonable assurance
 - C If the financial statements are found to contain material misstatements a negative audit opinion will be given
 - D An audit may not detect all fraud and error in the financial statements



2.5 Relationship between ISA and national standards

- ISAs do not have **legal status** and they represent best practice in auditing.
- If there is a conflict between ISAs and local audit requirement, the specific country regulation should be followed.

Which of the following statement is **false**?

- A. Auditing standards are laws which must be followed during all audits;
- B. Auditing standards should be followed during all audits unless there are exceptional circumstances which would mean the audit objective would not be met;
- C. Auditing standards are professional regulations;
- D. Auditing standards may be different in different countries, even those using ISAs

Which of the following are reasons for the audit profession issuing auditing standards?

- I. To ensure consistency of audits across different firms;
 - II. To provide bureaucracy for auditors;
 - III. To ensure quality in the standard of audit performed;
-
- A. All of them
 - B. (i) and (ii) only
 - C. (i) and (iii) only
 - D. (ii) and (iii) only

Which of the following people may act as auditor for a company?

- A. The company's previous finance director who left the company five years ago to join the audit firm
- B. A director of the company being audited who holds a valid audit certificate
- C. An employee of the company being audited who hold a valid audit certificate
- D. The wife of the finance director who works for a reputable audit firm

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In most jurisdictions, the auditors of the company will be appointed by which party?

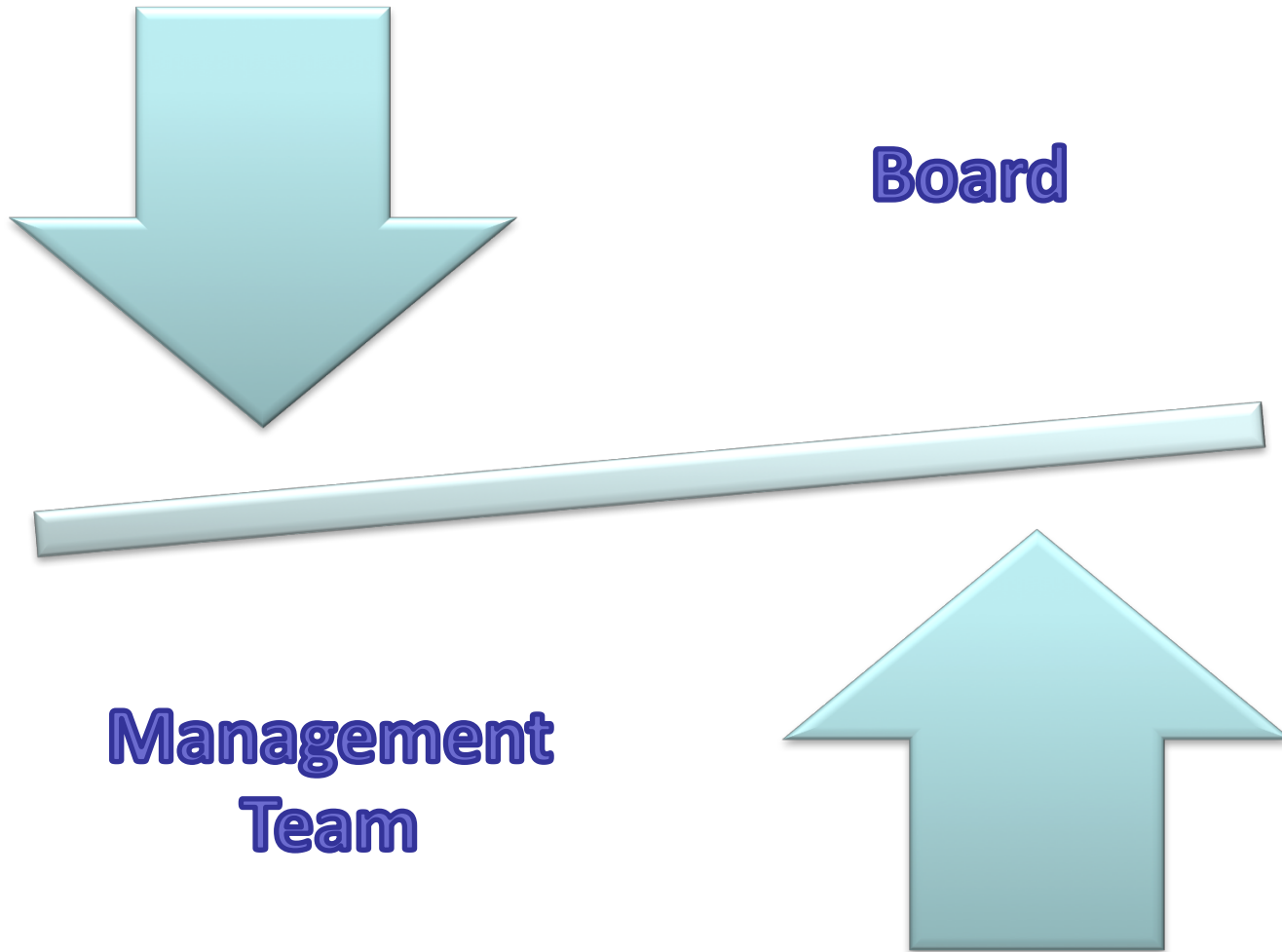
- A. Directors
- B. Audit committee
- C. Government
- D. Shareholders

Which of the following statements is true?

- A. The shareholders of most company will also be the directors
- B. The directors are the stewards of the company responsible for looking after the company on behalf of the owners
- C. Directors will always have a vested interest in the company doing well because they own shares in the company they work for
- D. Auditor are allowed to be business partners of the company directors

3

Corporate governance



Corporate governance refers to the way in which companies are **operated and controlled**.

- The aim of this is to ensure that companies are run well in the interest of their shareholders, employees, and other key stakeholders.
- This aim is to try and prevent company directors from abusing their power which may adversely affect these stakeholder groups.

EDs + NEDs = Board

- (i) **Executive directors**(EDs) – are involved in the day-to-day running of the company
- (ii) **Non-executive directors**(NEDs) are **independent**, part-time directors who scrutinise the company's affairs.
- (iii) NEDs should, as far as possible be “independent” of the company(i.e. not former employees).

- Listed company in UK: UK Corporate governance code. (Best Practice)
- UK CG Code: **comply or explain**

<u>Principles</u>	<u>Definition</u>
<u>Leaderships</u>	<i>Company should have a board as a brain; No-one should have unfettered powers of decision...</i>
<u>Effectiveness</u>	<i>balance of skills, independence in board; appointment of directors through transparent, formal, rigorous process...</i>
<u>Accountability</u>	<i>Risk-awareness in making decision; true assessment of company's position and future</i>
<u>Remuneration</u>	<i>Formal and transparent procedures for policy for executive directors remuneration</i>
<u>Relations with shareholders</u>	<i>Dialogue, AGM</i>

3.2.1 Leadership

- Every company should be headed by an **effective board.**
- **Chairman** should be **separated** from **CEO**.
(Clear division of responsibilities)
 - No one have unfettered powers of decision
- There should be a **balance** of EDs and NEDs. Ideally, **at least half** of the Board should be **NEDs**.
- A “**Nomination Committee**” comprising NEDs ensures there is no bias in board appointments.
- **Re-elect** directors periodically (annually or every 3ys)

3.2.2 Effectiveness

- Appropriate **balance of skills**, experience, independence and knowledge
- Directors should discharge responsibilities effectively
- Information should be processed in a timely manner
- All directors should **update skills and knowledge** regularly; **(receive induction)**
- There should be a formal annual **evaluation of its own performance**

3.2.3 Accountability

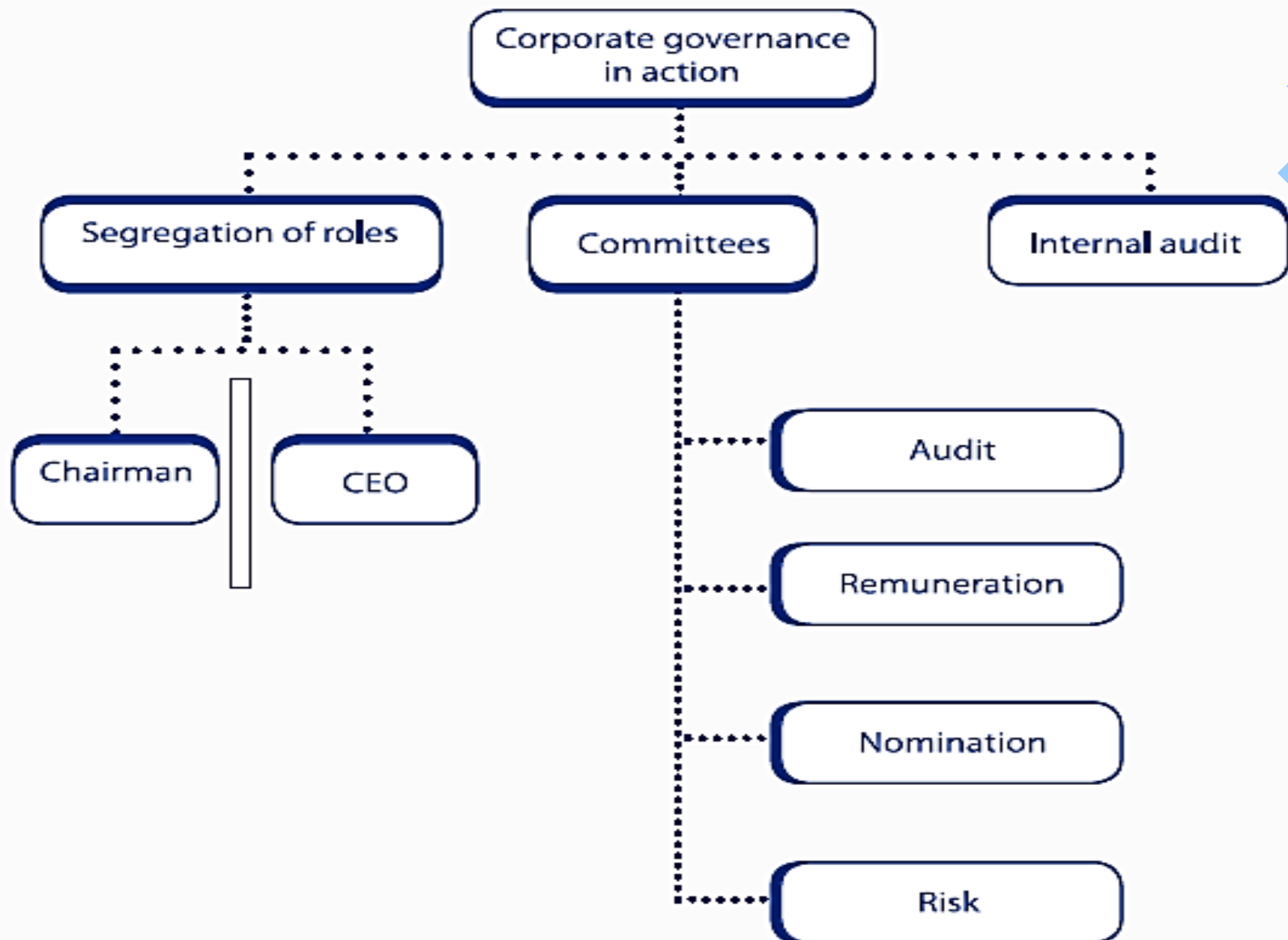
- The board should present a balanced and understandable assessment of the company's position and prospects.
- The board is responsible for assessing risks in achieving strategic objectives.
- There should be an “**Audit Committee**” responsible for applying appropriate internal control principles and maintaining relationship with the company's external auditors.

3.2.4 Director's remuneration

- **Formal and transparent procedure** for developing policy on executive remuneration
- A **Remuneration Committee** comprising NEDs should set remuneration levels for the board. (**“attract and retain”**)

3.2.5 Relations with shareholders

- The board should use the **AGM** to communicate with investors and to encourage their participation.
- **Dialogue** with shareholders



- Be made up of **at least 3 NEDs**
- The “bridge” between the internal and external auditors and the main Board
- Committee members should be **independent** of operational management
- **Responsibilities:**
 - **Internal audit respects**
 - ✓ Reviewing systems of internal controls
 - ✓ Agreeing agenda of work for the internal audit department
 - ✓ Reviewing the results of internal audit work

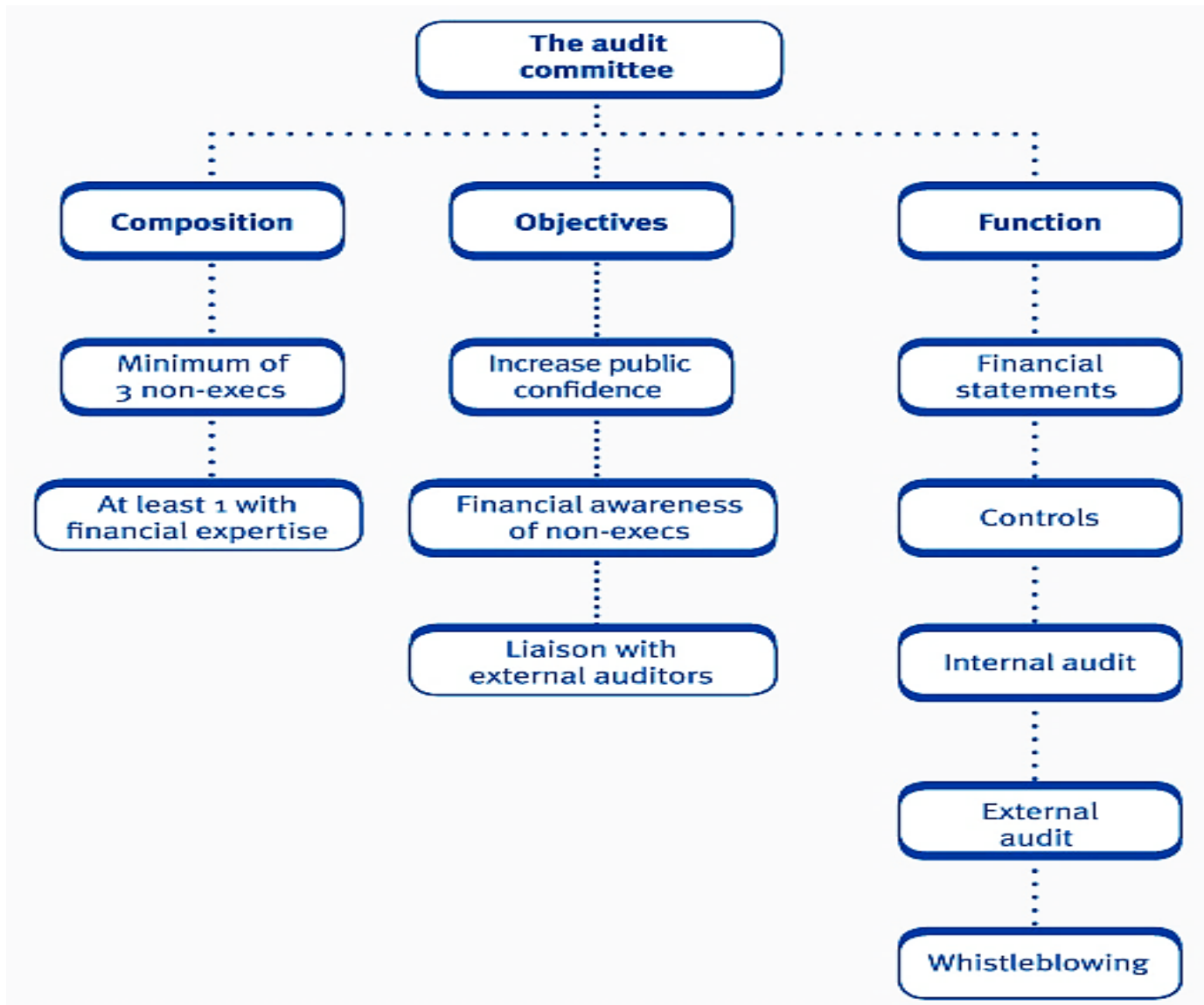
3.3 Audit committees

- **Responsibilities:**
 - **External audit respects**
 - ✓ Reviewing accounting policies and financial statements to ensure that they are appropriate
 - ✓ Reviewing the independence and competence of the external audit firm
 - ✓ Liaising with the external auditor if there are any queries/concerns
 - *The audit committee is considered to be more **independent** and can be **more objective**.*

3.3 Audit committees

- Other functions:

- ✓ Monitoring the integrity of financial statements
- ✓ Reviewing the company's internal financial control
- ✓ Reviewing arrangements for confidential reporting by employees and investigation of possible improprieties(***whistleblowing***)



3

3.4 Advantages of an audit committee

- More time
- Increased public **confidence in the credibility and objectivity**
- A form of **internal control**
- Financial reporting – one of the members should have **“financial expertise”**
- Bring valuable **skills, knowledge and expertise** to the company
- Easier and cheaper to arrange **finance**
- Meet listing requirements

- Finding suitable candidates
- Diminished importance of the board
- Slower decision-making
- Cost

3.6 Internal control and risk management



3.6 Internal control and risk management

Part of internal control should include the assessment of its key **business risks**

(i) **Financial risks** – affect the entity's cash flow

还债压力

(ii) **Compliance risks** – relating to laws and regulations

合规

(iii) **Operational risks** – relating to the day-to-day operations of the business

3.6 Internal control and risk management

Director's responsibility in respect of risk:

- **Implement** internal control and **monitor** their application and effectiveness;

EA

Auditor's responsibility in respect of risk:

- **Assess** the effectiveness of controls for reducing the risk of material misstatements of financial statements
- Incorporate this into overall **audit risk assessment** which allows them to design their further audit procedures
- Report **significant deficiencies** in client controls and any **significant risk** identified

Cocklebidy Co, a listed company, is currently reviewing its corporate governance practices to ensure they are compliant with regulations. The following is a description of the corporate governance policies they have in place:

- A remuneration committee comprise 3 NEDs;
- An audit committee comprising the finance director and the chief executive and 2NEDs;
- Separate people taking on the roles of chairman and chief executive

Which of the following best defines corporate governance?

- A. Corporate governance refers to the importance a company attaches to system and controls
- B. Corporate governance is the means by which a company is operated and controlled
- C. Corporate governance is the extent to which a company is audited, both internally and externally
- D. Corporate governance is an appraisal activity as a service to the entity.

In terms of the structure of the audit committee of cocklebidy, which of the following actions should be taken to become compliant with corporate governance regulations?

- A. A minimum of one NED should be recruited
- B. A minimum of one NED should be recruited and the finance director should be removed
- C. A minimum of one NED should be recruited and the finance director and chief executive should be removed
- D. No action necessary

Which **TWO** of the following are functions of audit committee?

- I. Planning the annual external audit
 - II. Reviewing the effectiveness of internal financial controls
 - III. Reviewing and monitoring the external auditor's independence
 - IV. Processing year-end journal adjustments to the financial statements
- A. i and iv
 - B. i and iii
 - C. ii and iv
 - D. ii and iii

Cocklebidy Co does not currently have an internal audit function. Which of the following summarises the requirements of corporate governance regulations in respects of internal audit?

- A. The audit committee must review the need for an internal audit function on an annual basis
- B. The audit committee must establish an internal audit committee as soon as possible
- C. There must either be an audit committee or internal audit function in place but there is no requirement to have both
- D. The finance director must review the need for an internal audit function and should make a request to the audit committee if it decided that an internal audit function would be beneficial

Which of the following is the main purpose of the remuneration committee?

- A. To ensure that the costs of the company are kept under control
- B. To ensure no director is involved in setting his own pay and the pay that is set is at an appropriate level
- C. To ensure decision making power for the company is not concentrated in the hands of one individual
- D. To ensure executives are paid a large basic salary irrespective of performance

3.7 Need for auditors to communicate with those charged with governance

EA

ED NED shareholder

治理层

- Those charged with governance means the person(s) with responsibility for overseeing the:
 - (i) Strategic direction of the entity
 - (ii) Obligations relating to the accountability of the entity

The main forms of **formal** communication:

- The Engagement letter(beginning) 业务约定书
- The Management letter(end) 管理层建议书

3.7 Need for auditors to communicate with those charged with governance

Matters to be communicated:

- (i) Planned scope and timing of the audit
- (ii) Auditor's responsibilities in relation to audit
- (iii) Auditor independence

3.7 Need for auditors to communicate with those charged with governance

(i) Significant findings from the audit, including:

- Changes in accounting policies, estimates and disclosures
- Any material risks and exposures
- Audit adjustments 审计调整，列出建议的更正会计分录，不是帮人家调好
- Material uncertainties 重大不确定性
- Disagreements with management
- Expected modifications
- Material weaknesses in internal control
- Written representations requested

management letter

- Focus on the **accounting and internal control systems-evaluate the effectiveness**
- To improve the management of the company and to help the company achieve its corporate objectives
- Normally performed by **employees** of the entity. (report directly to the audit committee)
- Staffed with **qualified, experienced** staff
- Appointment and remuneration controlled by an **audit committee**

5.1 Factors to consider when assessing the need for internal auditors

- It is considered to be best practice, **Not legal requirement**
- **The need for internal audit will depend on:**
 - ✓ Scale, diversity and complexity of activities
 - ✓ Complexity of operations
 - ✓ Number of employees
 - ✓ Cost/benefit considerations
 - ✓ The desire of senior management to have assurance and advice on risk and control

5.2 Codes of corporate governance about internal audit

- The UK Corporate Governance Code does not require companies to have an internal audit department.
- The Code requires the audit committee to consider **annually** whether one is needed.
- The audit committee is responsible for monitoring and reviewing internal audit activities.
- Internal auditors are not subject to the same qualification requirements as external auditors.



5.3 Internal audit VS External audit



	External	Internal
Objective:	Provide opinion	Advise management
Appointed by:	Shareholders or directors	Management or Audit committee
Reports to:	Shareholders	Management or Audit committee
Status:	Independent	Employee
Legal basis	Legal requirement	Not a legal requirement
Reports on& Responsibility	The truth and fairness of the financial statements and their compliance with the Companies Act and Accounting Standards	A wide range of issues including risk management and internal controls and corporate governance
Scope	Financial focus	All areas of the organization
Standards	ISAs	IIA, SOX, Combined code
Approach	Risk-- based	Increasingly risk-based

Key activities of the internal audit function:

- Whether the company is demonstrating **best practice in CG**
- Risk identification and management (**Key risk areas**)
- Testing Effectiveness of **internal controls**
- **Assessing Reliability** of financial and operating **information** (Accounting system)
- **Assessing Economy, efficiency and effectiveness** of operating activities (Value for money)
- Assessing **compliance with laws and regulations**
- Prevention and detection of fraud

- Fraud investigation
 - IT system review
 - Mystery shopper visits
 - Contract visits
 - Asset verification
 - ***Providing direct assistance to the external auditor***
- } Discuss later

6.1 Limitations of internal audit function

- To form an **objective independent** opinion despite the fact that internal auditors are normally **employees; (Internal offer: employed by the company)**
- **Insufficient resources** to form an effective IA function; (small organization)
- Fear of possible repercussions

IA may report to the audit committee to mitigate some of those problems

- Outsourcing is the contracting-out of a business process to a third party.
- Outsourcing internal audit can overcome **some** of the limitations caused by insufficient resources outlined above.

6.3 Advantages and disadvantages of outsourcing

➤ Advantages

- cost and efficiency
- broader range of expertise
- may improve independence
- costs of employing permanent staff are avoid

➤ Disadvantages

- conflict of interest if provided by the external auditor
- pressure on the independence of the outsourced function ,i.e. fees
- lack of knowledge of the business
- the decision maybe based on the cost
- flexibility and availability may not as high as in- house existing internal audit department

6.4.1 Value For Money (VFM)

- A value for money audit is concerned with obtaining the best possible combination of services for the least resources.

Economy

- Minimum cost
- Cost of medical suppliers per annum

Efficiency

- Outputs/inputs
- Number of patients treated per year

Effectiveness

- Achievement of goals and targets
- Recovery rates

6.4 Internal audit assignments

6.4.2 IT

- Hardware, software, internet and the overall IT environment

6.4.3 Financial

- Review of management accounts and systems
- Ensure the business is meeting its financial targets
- ***Where external auditors are most likely to rely on internal auditors***

6.4 Internal audit assignments



6.4.4 Regulatory compliance

- Meeting key legal requirements or specific legal requirements relating to the industry

6.4.5 Fraud investigations

- To ensure a fraud is not taking place
- Use lower materiality levels than external audit
- Investigate suspected fraud at an entity

6.4 Internal audit assignments



6.4.6 Customer experience

- Help the company to see itself from its customers' point of view
- To ensure it is meeting the customer needs
- Obtain customer feedback and analyse

6.5 Operational internal audit assignment

An operational IA assignment simply reviews the operations of a business, and so gives management assurance on the effectiveness of operations.

6.5.1 Procurement audit

- Procurement (purchasing) involves obtaining goods and services from outside suppliers at the right price.
- Key risks:
 - (i) Pay to non-existent suppliers
 - (ii) Inaccurate or late payments
 - (iii) Not getting best price from suppliers

IA can produce a similar report to management of external auditors.

Typical Report include:

- **Terms of reference:** the requirements of the assignment
- **Executive summary:** key risk and recommendation
- **Body of the report:** a detailed description of the work performed and the results of that work
- **Appendix**

Practice

firm

client

You are an audit manager of Satsuma & Co and have been assigned to the audit of Tangerine Tech Co (Tangerine), a company which is planning to list on a stock exchange within six months. The listing rules of the stock exchange require compliance with corporate governance principles, and the directors are unsure whether they are following best practice in relation to this. They have asked the audit engagement partner for their view on this matter.

Tangerine's board is comprised of six executive directors, a non-executive chairman and three other non-executive directors (NEDs). The chairman and one of the NEDs are former executive directors of Tangerine and on reaching retirement age were asked to take on non-executive roles. The company has established an audit committee, and all NEDs are members including the chairman who chairs the committee. All four members of the audit committee were previously involved in sales or production related roles.

All of the directors have been members of the board for at least four years. As the chairman does not have an executive role, he has sole responsibility for liaising with the shareholders and answering any of their questions. The company has not established an internal audit function to monitor internal controls.

review 需要

Required:

Using the information above:

Describe FIVE corporate governance weaknesses faced by Tangerine Tech Co and provide a recommendation to address each weakness to ensure compliance with corporate governance principles.

code { describe → identify → 原句
 → explain → 对比 → code
provide → action → 招人 reelection 制度: re establish
 换人 replace

(10 marks)

June 2011 exam Q4 (b)

Goofy Co's year end is 31 December, which is traditionally a busy time for NAB & Co. Goofy Co currently has an internal audit department of five employees but they have struggled to undertake the variety and extent of work required by the company, hence Goofy Co is considering whether to recruit to expand the department or to outsource the internal audit department. If outsourced, Goofy Co would require a team to undertake monthly visits to test controls at the various shops across the country, and to perform ad hoc operational reviews at shops and head office. Goofy Co is considering using NAB & Co to provide the internal audit services as well as remain as external auditors.

Required:

- (b) Discuss the advantages and disadvantages to both Goofy Co and NAB & Co of outsourcing their internal audit department. (10 marks)